Country Report

Kenya

Kenya at a glance: 2003-04

OVERVIEW

The president, Mwai Kibaki, and the new National Rainbow Coalition (NARC) government are committed to extensive reforms, with the aim of reviving Kenya's moribund economy. Despite the likely return of external funding before the end of 2003, progress with reform will inevitably be slow because of the magnitude of the task. The fight against corruption shows no sign of easing and several high-level prosecutions are likely in the outlook period. The new regime has restored confidence in the future, but will increasingly be judged on performance rather than rhetoric. Divisions within NARC will test the president's political skills. Most parties in the coalition favour a formal merger, but this remains anathema to the Liberal Democratic Party (LDP), which could leave the coalition. This would not deprive the government of a majority but would damage its credibility. Real GDP is forecast to grow by 1.5% in 2003, driven by agricultural output. Stronger economic growth of just over 3% is forecast for 2004, but this will fall short of the official 4.6% target and make little impact on poverty or unemployment.

Key changes from last month

Political outlook

- Following the recent death of the vice-president, Michael Kijana Wamalwa, a power struggle appears to have emerged within the diverse NARC. One potential candidates for the top job is Raila Odinga, leader of the LDP. This would place him in a strong position to contest the presidency in 2007 (or even earlier if Mr Kibaki's health also deteriorated). Other front runners include the minister of education, George Saitoti; Moody Awori; and the youthful minister for foreign affairs, Kalonzo Musyoka.

Economic policy outlook

- Economic reforms, supported by donors, will remain in place, although privatisation is not expected to make much headway.

Economic forecast

- Economic prospects remain essentially unchanged from last month.

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London
The Economist Intelligence Unit
15 Regent St
London
SW1Y 4LR
United Kingdom
Tel: (44.20) 7830 1007
Fax: (44.20) 7830 1023
E-mail: london@eiu.com

New York
The Economist Intelligence Unit
The Economist Building
111 West 57th Street
New York
NY 10019, US
Tel: (1.212) 554 0600
Fax: (1.212) 586 0248
E-mail: dantecantu@eiu.com

Hong Kong
The Economist Intelligence Unit
60/F, Central Plaza
18 Harbour Road
Wanchai
Hong Kong
Tel: (852) 2585 3888
Fax: (852) 2802 7638
E-mail: hongkong@eiu.com

Website: **www.eiu.com**

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Outlook for 2003-04

Political outlook

Domestic politics

Kenya's president, Mwai Kibaki, and his National Rainbow Coalition (NARC) face serious challenges in carrying out their electoral promises, which include a wide range of political and economic reforms, over the forecast period. The new regime has inherited run-down infrastructure, weak and corrupt institutions, a country riven with ethnic divisions, and one of Africa's worst-performing economies. Although the new regime has been fulfilling specific electoral pledges, such as tackling corruption and introducing free primary education, Mr Kibaki has struggled to keep his broad-based coalition together. Membership of NARC is diverse and cuts across traditional boundaries of ethnicity and ideology. The feeling of triumph generated by the election victory in December 2002 is now fading, and the tensions inherent in NARC have increasingly become apparent, particularly following the recent death of the vice-president, Michael Kijana Wamalwa, who played a key role in securing victory for NARC.

Potential candidates for the role of vice-president within NARC include Raila Odinga, leader of the Liberal Democratic Party (LDP). This would place him in a strong position to contest the presidency in 2007 (or even earlier if Mr Kibaki's health also deteriorated). Other front runners include the minister of education, George Saitoti (a "Masai" of Kikuyu origin); 70-year old Moody Awori (from the Luhya community); and the youthful minister for foreign affairs, Kalonzo Musyoka (a LDP member of Kamba origin; the Kamba are cousins of the powerful Kikuyu). A recent opinion poll clearly showed a preference for the foreign minister, but his appointment could be politically risky for the already disgruntled LDP wing of the coalition.

Tensions within NARC will also be generated by the constitutional review process and the divergence of opinion as to how the party should evolve over time. Mr Kibaki will need to exert all his authority to keep NARC from fracturing. The main division within the coalition is between the LDP and the group of parties lined up behind the president. LDP members consistently accuse the NARC leadership of violating the memorandum of understanding agreed in October 2002, which appeared to offer Mr Odinga the post of prime minister. This post does not currently exist but the draft of the new constitution produced last year called for the creation of a powerful executive prime minister. However, many doubt the wisdom of such a strategy, as the emergence of twin centres of power could lead to divided and ineffective government. To the LDP this is yet another slap in the face. Mr Odinga has, to date, been able to calm his fractious LDP colleagues and has sought to distance himself from the controversy over whether Kenya should have a prime minister by saying that personality issues should play no part in the debate. However, Mr Odinga is highly ambitious and views his position as minister of public works as no more than a stepping stone towards higher office. His sights have shifted, however, and he may now view promotion to the vice-presidency as a more effective route to ultimate power.

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International relations

The international community has welcomed the smooth transfer of power and Mr Kibaki's promise of fundamental economic reforms and efforts to combat corruption. The IMF and the World Bank have commended NARC's performance to date and are expected to normalise relations before the end of the year. The government and its Western partners are now more concerned with the threat posed to national security by Islamist terrorists operating under the al-Qaida banner. The US, in particular, has pressed the government to take firm action and has pledged US$100m in support of the fight against terrorism in Kenya.

Economic policy outlook

Policy trends

The task of reviving Kenya's moribund economy is the main challenge facing the new minister of finance, David Mwiraria, and his colleague, the minister of planning, Anyang' Nyong'o, over the forecast period. The government launched a highly ambitious policy blueprint in June—the Economic Recovery Strategy for Wealth and Employment Creation. This promises 500,000 new jobs annually; real GDP growth of 4.6% per year; average annual inflation under 5%; an average investment/GDP ratio of 23.3%; and real private consumption growth of 4.4%. The government has identified improved security and public-sector governance as the catalyst for economic revival, hoping to create a climate conducive to private-sector investment. Following the successful conclusion to the IMF's Article IV consultations in May and the visit by the IMF's managing director, Horst Köhler, in July, the prospects for normalising relations with donors are good. Kenya has met most of the preconditions for a resumption of IMF assistance, particularly the passage of anti-corruption legislation and the prosecution of offenders. The IMF is expected to receive a letter of intent within weeks, allowing for the return of bilateral funding. Kenya's return to the IMF fold will pave the way for other crucial support and a rescheduling of Paris Club debt. However, the resumption of donor funding will be gradual and the fiscal account will remain under pressure. The new government will move cautiously on privatisation and will not dispose of parastatals—such as Kenya Commercial Bank, Telkom Kenya, Kenya Railways Corporation and Kenya Ports Authority—until the companies return to profit.

Fiscal policy

NARC's first budget for fiscal year 2003/04 (July-June), which was released in June, projects a deficit of 6.2% of GDP, compared with 4.8% of GDP in 2002/03. The increase is due to slow revenue growth—to KSh236.5bn (US$3.13bn)—because of the sluggish economy, combined with a more rapid rise in spending—to KSh320bn—as the government fulfils its commitment to free education and investment in infrastructure, particularly roads. Grants are forecast to rise modestly to KSh21.1bn, and the fiscal deficit is projected at KSh62.5bn. Wages and salaries consume about 40% of current spending, a figure that is unlikely to fall in the forecast period owing to the implementation of several pay awards for civil servants, a move considered necessary to reduce incentives for corruption. To stimulate private consumption and investment, the government has introduced several tax and duty cuts, including a reduction in VAT from 18% to 16%, and has lowered the threshold for import duty savings on new investments from US$5m to US$70,000. Taken together, these measures

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should help to boost investment. Increased spending will be partly funded by improved tax collection, a rise in the duty on mobile telephone calls from 5% to 10% and the projected receipt of at least KSh3.7bn from the award of a third mobile licence in December—the only privatisation proceeds factored in to the budget. The Economist Intelligence Unit expects the fiscal deficit to shrink in 2004/05 as reforms gather pace and donor funding increases.

Monetary policy

Monetary policy will be geared towards keeping inflation below the official 5% target and maintaining exchange-rate stability. Fears that the government's almost exclusive reliance on domestic borrowing would push up interest rates have not yet been realised. The benchmark rate on 91-day Treasury bills fell from 8.4% in December to 1.5% in July as high levels of liquidity in the banking system, coupled with banks' characteristic aversion to lending to the private sector, fuelled demand for government paper. Of more concern is the wide spread between different rates, which is the subject of a study due for completion in October. The Central Bank of Kenya (CBK) has lengthened the maturity profile of government debt, and the ratio of Treasury bonds to bills is nearing the 70:30 target. The growing importance of medium-term bonds will facilitate the development of capital markets.

Economic forecast

International assumptions

International assumptions summary
(% unless otherwise indicated)

	2001	2002	2003	2004
Real GDP growth				
World	2.2	2.9	3.2	3.9
OECD	0.9	1.8	1.7	2.4
EU	1.5	1.0	0.7	1.9
Exchange rates				
¥:US$	121.5	125.3	118.1	116.8
US$:€	0.896	0.945	1.123	1.183
SDR:US$	0.785	0.772	0.718	0.702
Financial indicators				
€ 3-month interbank rate	4.26	3.33	2.27	2.25
US$ 3-month Libor	3.78	1.80	1.11	1.42
Commodity prices				
Oil (Brent; US$/b)	24.5	25.0	26.8	18.9
Gold (US$/troy oz)	271.1	310.3	343.3	317.5
Tea (US$/kg)	1.6	1.5	1.5	1.4
Coffee (Arabica; US cents/lb)	62.3	61.5	64.5	60.9

Note. Regional GDP growth rates weighted using purchasing power parity exchange rates.

Global GDP growth in 2003, at just 3.2% using purchasing power parity weights, will be disappointing, despite a modest pick-up in the second half of the year. A return to more normal rates of growth in most major markets by the second half of 2004 should allow world GDP to expand by a healthier 3.9% in 2004. However, we expect the recovery in the EU—critical for Kenyan trade—to be markedly weaker: after growing by 1% in 2002, real GDP is forecast to expand by an even more modest 0.7% in 2003, before picking up to 1.9% in 2004. The outlook for Kenya's main commodity exports, such coffee and tea, is mixed.

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Although coffee prices have rallied slightly in 2003—we expect the price of arabica coffee to average 64.5 US cents/lb in 2003—prices are still forecast to fall back in 2004 as oversupply continues to plague the market. Tea prices are also being affected by oversupply and we expect them to continue drifting down in 2003-04. We have marginally raised our forecast for the average price of dated Brent Blend in 2003 to US$26.8/barrel, mainly because post-war disorder in Iraq has caused unexpectedly long delays in the recovery of its oil production. We expect Brent to fall sharply to an average of US$18.9/b in 2004, the lowest level since 1999, as the market eliminates the war price premium and weak market fundamentals reassert themselves.

Economic growth

Growth in the Kenyan economy has remained sluggish in 2003: real GDP grew by 1.4% (annualised) in the first five months of the year compared with 1.1% in the same period of 2002. Although agriculture has benefited from better weather, large-scale donor support is not expected to resume until the fourth quarter and domestic demand remains weak. The Central Bank forecasts growth of 2% for the full year, although we expect the figure to be slightly lower, at 1.5%, because of the sharp downturn in tourism following recent security alerts. Stronger economic growth of just over 3% is forecast for 2004, but this will make little impact on poverty or unemployment. The agricultural sector is forecast to pick up in 2003-04, assuming normal rainfall. Projected new investment in telecommunications, higher textile production and improved electricity supplies should boost industrial growth to 1.8% in 2003 and a more impressive 3.3% in 2004. Growth in the services sector will be hampered by the downturn in tourism following the UK's six-week suspension of commercial flights to Kenya in mid-year because of the perceived threat of terrorism. In 2004 a recovery in tourism, combined with increased activity in trade and finance, will boost the growth of services.

Inflation

Annual inflation rose to 7.3% in July, from 1.9% in December, owing to food shortages following a spell of unusually dry weather and the sustained strength of world oil prices. Import price inflation remains low owing to the appreciation of the Kenya shilling and subdued domestic demand. Inflation is now subsiding because of improved food supplies and tax cuts in the 2003/04 budget, and is forecast to average 5.5% in 2003. Although domestic demand will be stronger in 2004, oil prices are expected to fall sharply, and we expect inflation to ease to 3%, given satisfactory rainfall.

Exchange rates

Following a long period of stability, the Kenya shilling appreciated strongly in the first five months of 2003, from KSh77.7:US$1 in January to KSh71.6:US$1 in May. This reflected the weakness of the US dollar, seasonal inflows of foreign exchange from tea sales and the prospect of renewed external financing. The Central Bank subsequently intervened in the market to reverse this trend, which threatened to erode Kenya's export competitiveness, and the shilling depreciated to KSh78.1:US$ on September 15th. We expect the shilling to continue to come under periodic pressure until IMF lending is resumed. The exchange rate is forecast to average KSh75.54:US$1 in 2003, before weakening slightly to KSh76.04:US$1 in 2004.

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External sector

Prospects for Kenya's current account in 2003-04 remain essentially unchanged. In 2003 exports will continue to suffer from weak growth in the key EU market and from continuing infrastructure constraints, but external demand will be bolstered by moves towards regional integration and opportunities afforded by the Africa Growth and Opportunity Act, which offers preferential access to the US market. Imports will edge up in 2003 because of high oil prices and cuts in duty on capital equipment in the 2003/04 budget. Imports will receive a further boost following the resumption of large-scale donor funding, which will stimulate domestic activity, although this is not expected to take place until the fourth quarter. Tourism will remain subdued in 2003, although current transfers will pick up in the second half of the year. Both exports and imports are projected to rise more rapidly in 2004: faster world growth will boost external demand and the impact of renewed donor funding on imports will be more widely felt. In addition, a recovery in tourism, combined with Kenya's growing importance as a regional centre for financial services, should bolster invisible earnings. Stronger donor support will also push up current transfers in 2004. Overall, we expect a current-account deficit of 1.3% of GDP in 2003 and 1.6% of GDP in 2004.

Forecast summary
(% unless otherwise indicated)

	2001[a]	2002[b]	2003[c]	2004[c]
Real GDP growth	1.1	1.1[a]	1.5	3.1
Industrial production growth	0.7[b]	1.2	1.8	3.3
Gross agricultural production growth	1.2	0.7	1.6	2.0
Consumer price inflation (av)	5.7	1.9[a]	5.5	3.0
Consumer price inflation (year-end)	0.6	2.5[a]	4.5	2.5
Short-term interbank rate	19.7	18.4[a]	16.0	14.0
Government balance (% of GDP)	-4.3	-3.7	-4.8	-6.5
Exports of goods fob (US$ bn)	1.9	2.2	2.3	2.5
Imports of goods fob (US$ bn)	3.2	3.2	3.4	3.6
Current-account balance (US$ bn)	-0.3	0.1	-0.2	-0.2
Current-account balance (% of GDP)	-2.8	0.5	-1.3	-1.6
External debt (year-end; US$ bn)	5.8	5.6	5.9	6.2
Exchange rate KSh:US$ (av)	78.56	78.75[a]	75.54	76.04
Exchange rate KSh:¥100 (av)	64.65	62.82[a]	64.51	65.84
Exchange rate KSh:€ (year-end)	69.27	80.83[a]	88.83	88.65
Exchange rate KSh:SDR (year-end)	98.8	104.8[a]	107.6	108.1

[a] Actual. [b] Economist Intelligence Unit estimates. [c] Economist Intelligence Unit forecasts.

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All queries: Tel: (44.20) 7830 1007 E-mail: london@eiu.com **Next report:** Full schedule on www.eiu.com/schedule

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